15 February 2013

Mr Warwick Anderson
General Manager – Network Regulation Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr Anderson

Better Regulation – Rate of Return Guidelines – Issues Paper

Energex Limited (Energex) appreciates the opportunity to provide written submissions on the Australian Energy Regulator's (AER) Rate of Return Guidelines Issues Paper (Issues Paper).

The amendments to the cost of capital provisions in the National Electricity Rules (Rules) are significant and require a fundamentally different approach to estimating the required rate of return for distribution determinations. A wide range of evidence must be considered in order to estimate rates of return that best meet the new allowed rate of return objective and are in the long term interests of consumers.

Energex recognises the practical challenges associated in holistically synthesising inconsistent evidence. Energex expects that during the course of the proposed methodology development, data analysis and workshops, potential approaches to distilling evidence will be narrowed. The types of evidence to be taken into account might guide the types of approaches that could be reasonably considered. Energex looks forward to contributing collaboratively to this investigation.

Energex provides an attached submission on the Issues Paper questions. Energex also supports the submissions from the Energy Networks Association and Queensland Treasury Corporation.

If you have any questions in relation to Energex's submission please contact Alex McPherson, Acting Network Regulation Manager on (07) 3664 4104.

Yours sincerely

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AER Rate of Return Guidelines

Issues Paper

Energex Submission

15 February 2013

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1 Response to Issues Paper Questions

1.1 Principles Based Approach

1.1.1 Principles for assessing rate of return principles

Question 1 Do stakeholders consider that following these principles would promote the allowed rate of return objective? Should any of the principles be considered as more prominent or important than others?

Question 2 Are there other principles or criteria which should be considered?

Employing a set of pre-defined principles can help translate the overarching requirements of the Rules into practical guidance for the detailed rate of return analysis and consultation. Energex believes that the principles should:

- Be clearly defined and not be open to materially different interpretations;
- Be efficient, in that they are not repetitive, self-evident or duplicate pre-existing legislative requirements for the decision-making process;
- Not replace, restrict, nor be inconsistent with the requirements of the National Electricity Law and Rules, including the National Electricity Objective, Revenue and Pricing Principles and Allowed Rate of Return Objective; and
- Not promote irrelevant objectives.

Attachment 1 provides Energex's comments on each of the Issues Paper's 13 proposed principles for the rate of return methodologies. Energex supports a number of the proposed principles although considers that some are difficult to reconcile with the above considerations. Energex believes that the following 6 principles, which are based on the proposed principles, would better reflect these considerations:

- Financial model evidence has a sound theoretical foundation;
- The analysis is transparent and replicable;
- The analysis acknowledges and addresses output uncertainty and instability;

- The methodology avoids filtering or adjustment to data unless undertaken on an economic basis;

- Regulatory judgement is exercised in a manner which is demonstrated to be consistent with the allowed rate of return objective and the intention of the Rules; and

- The methodologies support reasoned, transparent and predictable decision-making.

In regard to the exercise of regulatory judgement, Energex believes that the following comment from the AEMC's Directions Paper (p. 85) is instructive:

> *"it is incumbent on the regulator to identify and* ***explain clearly*** *where and when it has made the necessary trade-offs against precision in its estimates of parameter values and the overall reasonableness of WACC estimates"* [emphasis added].

Energex considers that a concise set of principles would reduce the scope for:

- Opportunistic and inappropriate utilisation of the principles; and

- The Guidelines consultation to devolve into a debate about the interpretation of the principles.

Further it may be ineffective and inefficient to provide evaluations of individual pieces of evidence and analysis[1] against 13 principles. Energex believes that 6 principles would provide a better balance in this regard, noting that the broader legislative objectives need to be considered and take precedence.

In Energex's view, it is unlikely that the Guidelines will result in an unqualified and uncontentious approach to estimating the overall rate of return. The proposed approach to balancing different sources of evidence which are considered potentially useful will be a particular focus. The Issues Paper does not explicitly cover this important matter. There are likely to be a number of approaches to balancing evidence, including:

- Ranking relevant evidence based on the perceived ability to promote the allowed rate of return objective and then assigning numerical weights (e.g. 50% + 30% + 20%). This approach may not be transparent;

- Taking a view on the preferred source of evidence and assigning 100% weight to it as the proposed source. This may not be consistent with the intention of the Rules to take into account relevant evidence in the preferred methodology. The

[1] The AER has stated that it expects stakeholders to provide this evaluation, refer Issues Paper p.21.

effective assigning of 0% weight to other relevant sources could be seen as still ‘taking into account’ these sources, but Energex considers that this may be an inappropriately narrow view of the intention of the Rules;

- Taking a view on the preferred source of evidence and assigning 100% weight to it as the proposed source, subject to a process of ‘sanity checking’ or ‘cross checking’ this against outcomes from other evidence. Energex has reservations about this approach, because it is reasonably unclear and unpredictable in implementation; and

- Adopting a similar approach as that presented to the Australian Competition Tribunal in the merits review of the gamma factor (the ‘football-field’ approach). Energex believes that this approach, if constructed and implemented in a balanced manner, could be the most consistent with the intention of the Rules because all relevant information will directly influence the final estimate. However, like all approaches, it will involve challenges in implementation which need to be considered.

Energex believes that the approach to balancing evidence is likely to be a key driver for stakeholder positions on rate of return estimation during the consultation. Therefore Energex would welcome the AER’s views on the strengths and weaknesses of such approaches in the Consultation Paper. Energex believes that balancing of evidence, along with the “principles”, could be brought together into a proposed rate of return “decision-making framework” for consideration. The worked example included in the Final Guidelines would demonstrate how the AER would implement the framework at that time.

1.1.2 Implementing a principles based approach

Question 3 Do stakeholders have a broad preference for predictability or flexibility, and do these preferences differ at each level (the overall rate of return, the return on equity and debt, and at the parameter level) of the rate of return?

Question 4 To what extent should the guideline set out a pre-determined approach that can then be applied at each determination?

Energex believes that the Rules provide guidance as to the degree of predictability and flexibility required by the proposed rate of return methodology, including whether a pre-determined approach can be included in the Guidelines.

To be compliant with the Rules, the Rate of Return Guidelines should set out:

- The AER's proposed rate of return methodologies; and
- How those methodologies would result in the determination of a return on equity and debt that best meets the allowed rate of return objective.

In Energex's view, the requirement to demonstrate consistency with the allowed rate of return objective will require a reasonable degree of prescription to be included in the Guidelines regarding the proposed approach to estimating the overall rate of return, the return on equity and return on debt. Further, certain parameters may be considered to remain reasonably static over a 3 year period (e.g. gamma, benchmark gearing, benchmark credit rating, asset betas, size factors). There may be opportunities to provide indicative values in the Guidelines, to the extent they are used as part of the proposed rate of return methodologies.

The proposed approaches should be sufficiently flexible that the AER can meet the requirements of the Rules at each Distribution Determination, including that the AER must have regard to:

- The information included in the NSP's regulatory proposals (which may include, for example, a proposed return on debt methodology);
- Estimation methods, financial models, market data or other evidence including that which arises between the publication of the Rate of Return Guidelines and the Distribution Determination;
- The degree of consistency and any interrelationships between estimates of parameters in the return on equity and debt;
- Prevailing conditions in the market for equity funds; and
- The return on debt estimation factors listed in clause 6.5.2(k) of the Rules.

Energex would strongly support a worked example of how the rate of return methodologies would be implemented if the AER was required to make a distribution determination around the time of the Final Guidelines publication.

1.2 Key concepts and terms

1.2.1 Efficient financing costs

Question 5

Aside for a balance between debt and equity financing, are there other characteristics of the way in which an efficiently financed entity would approach its financing task that should be considered in estimating the allowed rate of return?

An efficiently financed entity seeks to ensure it has sufficient funding available at least cost to ensure operational sustainability. To meet this objective an efficiently financed entity will balance the desire to reduce financing risk by raising debt:

- Prior to its actual requirement;
- From diversified sources and facilities;
- With staggered maturity dates; and
- Of a term which matches the life of its assets;

with any additional costs imposed by these financing approaches. The efficiently financed firm will also seek to minimise any other debt raising costs (e.g. underwriting fees, hedges).

It is important to note that the outcomes of this assessment can differ across entities and over time. Reasons for these differences include:

- The yield curve can change over time, which alters the relationship between term to maturity and the cost of debt. A notable example was the change in the yield curve caused by the Global Financial Crisis; and
- The expected size of the financing task can differ significantly across entities (due to differences in gearing and firm size) and over time (due to new capital expenditure requirements).

It is therefore critical to recognise that there is no single efficient financing approach for all entities. There are good reasons why efficiently financed entities adopt different approaches to managing their debt portfolio.

There is another significant driver for the diversity in efficient financing approaches for *regulated electricity networks*. Treasurers of regulated electricity networks need to manage the risk that the interest expense provided through a regulatory determination differs from the actual interest expense incurred by the business ('interest rate risk'). Under the previous Rules, this could be achieved through refinancing the business' entire debt portfolio during the averaging period or using interest rate hedges. The adopted approach is generally dependent upon the size of the debt portfolio. It may be considered imprudent to refinance an entire debt portfolio during the averaging period as it exposes the businesses to opportunistic behaviour by market participants. An alternative approach is to use interest rate hedges. This is also extremely difficult and costly for businesses with large debt balances. Further, the business could still be exposed to basis risk and it could not hedge the debt risk premium.

In Energex's view, the potential for a diversity of efficient debt financing approaches means that it is important that an appropriately diverse set of benchmark efficient entities be considered and developed in relation to the return on debt. If a single cost of debt benchmark is adopted, there would be a case for including an additional principle in the list of rate of return methodology principles:

> *"The methodology avoids creating incentives for inefficient financing"*.

1.2.2 Benchmark efficient entity

Question 6 Is it still appropriate to separate a conceptual benchmark from its practical implementation?

Energex believes that it is appropriate to separate a conceptual benchmark from its practical implementation.

Energex considers that there could be a single benchmark for estimating the return on equity and gearing, similar to the approach adopted in the 2009 Statement of Regulatory Intent. However, it is unlikely that there will be a firm, or group of firms, which is identical to such a benchmark and therefore the practical implementation needs to appropriately take this into account.

As noted in response to Question 5, Energex considers there is a case for a number of benchmark approaches to efficient debt financing to be included in the Rate of Return Guidelines. This would reflect the intention of the Rules.

At each regulatory determination, the NSP and the AER would then compare the NSP to the return on equity and gearing benchmark(s), and the debt benchmark considered most proximate and appropriate for the NSP. These benchmarks and their associated proposed rate of return methodologies could be used to inform the NSP's allowed rate of return if appropriate at that time.

Question 7

Does the current definition reflect an appropriate level of detail for the conceptual definition? Are there other factors which should be considered?

Question 8

In relation to the current definition of the conceptual benchmark, is more or less detail preferable?

Energex has commented above regarding the factors likely to be relevant to the benchmark firm(s) in the context of estimating the required return on debt.

The conceptual definition for the benchmark firm relevant to assessing the efficient return on equity should cover the characteristics which are potentially relevant to estimating the efficient return on equity.

An important issue will be to determine whether and to what extent such factors influence the required return on equity of the NSP providing standard control services, by analysing methodologies which take these factors into account. It may be pre-emptive to define a benchmark for the return on equity before such an analysis is undertaken.

Question 9

Are the proposed factors reasonable?

Question 10

Are there other factors which should be considered?

Energex believes that, other things equal, the use of larger samples will result in more precise and robust estimates. On this basis, all data should be included in the sample unless there is a very clear reason to exclude it. If there are grounds for questioning the exclusion, the exclusion should be clearly justified by the party proposing the exclusion.

The Issues Paper states that the rate of return estimate should reflect the observed behaviour of actual regulated firms. In Energex's view the actual behaviour of NSPs will be relevant to establishing the allowed rate of return methodologies. However, the efficient approach to debt financing for a NSP will depend upon, in part, the approach to estimating the regulatory cost of debt. Therefore, it is important to consider the approach to issuing debt in the absence of regulation, rather than the current approaches which are influenced by the approach to estimating the regulatory cost of debt set out in the previous Rules.

1.2.3 Similar degree of risk

Question 11 Are there characteristics that differentiate the level of risk in the gas and electricity sectors or between distribution and transmission networks?

Question 12 Are there other characteristics that should be taken into account when assessing the level of risk?

Question 13 To the extent that different risk levels exist, can these differences be estimated in a manner consistent with the regulatory principles outlines in section 2?

Energex is an electricity distribution network service provider only and so does not comment upon the risk characteristics of gas network or electricity transmission businesses relative to electricity distribution.

Energex believes the following characteristics of the benchmark efficient firm may be potentially relevant when assessing the risks relevant to the allowed return on equity:

- The nature of the service provided;
- Leverage;
- Firm size; and
- Book to market value.

Energex discusses relevant factors for estimating the cost of debt in response to Question 5.

1.3 Overall rate of return

Question 14 To date our practice has been to estimate the allowed rate of return based on the standard WACC formula. Should be continue with this, or if not, what alternative approaches should be explored?

Energex supports the use of the nominal vanilla WACC formula as the basis for the preferred rate of return methodology.

Question 15 How can overall rate of return considerations be used under the new rule framework? This may include consideration of the relevance of the methodologies identified above (or others not yet identified), and how such information could be used.

Under the Rules, the types of information and methodologies identified (such as financeability tests and broker reports) might be best used to inform the return on equity methodologies, return on debt methodologies, and the gearing methodologies used to estimate the overall allowed rate of return. The information and methodologies may be difficult to use to directly estimate or adjust the allowed rate of return.

1.4 Return on equity

Question 16 Are the assessment criteria presented in section 3.1 an appropriate basis for evaluating the cost of equity methodology in order to meet the allowed rate of return objective?

Energex's comments on the principles in section 3.1 are provided in response to Question 1.

Question 17 What overall cost of equity methodology best meets the allowed rate of return objective?

Question 18 What individual cost of equity model best meets the allowed rate of return objective?

In Energex's view it is important to explore potentially relevant cost of equity models and other evidence before determining proposed cost of equity methodologies. This process would involve an assessment of all potential evidence, including the Sharpe-Lintner CAPM, against the principles and legislative requirements.

Energex also notes that the Issues Paper states that (p. 21):

> *We do not seek views at this stage on the appropriate estimation of [the Sharpe-Lintner CAPM] parameters.*

It would be inappropriate to provide a view on the optimal cost of equity model without having the opportunity to express views on Sharpe-Lintner CAPM parameter estimation within the legislative requirements for the allowed rate of return.

Energex also believes that the return on equity should be greater than the return on debt for the same firm. Therefore, and as reflected in the Rules, the return on equity methodologies should not be considered in isolation and independently of potential return on debt methodologies.

Question 19 What other evidence (estimation methods, financial models, market data and other estimates) is relevant to the determination of the cost of equity.

Energex notes that the following evidence has previously been raised in the context of the return on equity under the Rules:

- Financial models: Dividend Growth Model, Fama-French 3-factor model, Sharpe-Lintner CAPM, Black CAPM; and
- Relevant expert opinion on the cost of equity, sourced from surveys, reports or experts directly.

1.5 Return on debt

Question 20 What are the advantages and disadvantages or portfolio approaches compared with the current “on the day” approach to the return on debt?

Question 21 How do these approaches align with the principles of an efficient financing benchmark, as set out in section 4.2?

Question 22 What are the characteristics of the efficient and prudent financing practices that should be taken into account under a benchmark framework?

Energex believes that a portfolio approach, if appropriately implemented and applied, has a number of advantages. Energex’s supports Queensland Treasury Corporation’s submission in this regard.

It is also important that approaches to estimating the cost of debt put forward by stakeholders are constructively assessed. In Energex’s view, a robust assessment framework does not result in the rejection of otherwise effective cost of debt approaches solely on the identification of potential problems. It is important that the materiality of these problems is assessed, and the AER seeks to overcome these problems via constructive engagement with the proposing party and in light of the allowed rate of return objective.

Attachment 1 – Energex Comments on Allowed Rate of Return Principles

Issues Paper Principle	**Energex Comments on Issues Paper Principles**	**Energex Proposed Principle(s)**
1. Driven by economic principles (a) The methodologies have a strong theoretical foundation; (b) The methodologies are fit for the purpose of estimating the required rate of return; (c) The methodologies are internally consistent; (d) The regulator has regard to prevailing market conditions.	• It is not clear whether the "economic principles" are those principles listed in (a)-(d). Energex does not consider that any of these principles could be characterised as 'economic' principles; • It is not clear how the "theoretical foundations" of potential evidence other than financial model evidence can be reasonably assessed (e.g. the theoretical foundations of broker reports). This may operate to circumvent the requirements of the Rules that a range of evidence (beyond financial models) is considered; • In Energex's view the theoretical foundations of a financial model sound not be assumed or inferred solely based on the prevalence of its use; • That the methodologies are fit for purpose is self-evident. Energex considers that this principle is unnecessary; • It is Rules requirement that the AER have regard to the desirability of approaches that lead to the consistent application of financial parameters estimates that are common to the return on equity and debt; and	Financial model evidence has a sound theoretical foundation.

	• The AEMC's Final Determination specifically notes that there is no requirement to consider prevailing market conditions when estimating the allowance for the return on debt since the final rule (and the draft rule) allows the return on debt to be estimated with reference to an historical average as well to the prevailing conditions in the market (p 64 Final Determination). Therefore Energex considers that this principle is inappropriate because it is inconsistent with the intention of the Rules.	
2. Supported by robust analysis: (a) The analysis is transparent and replicable; (b) The analysis appropriately acknowledges uncertainty; (c) The analysis output is not unduly sensitive to small changes in inputs.	• Energex supports principle 2(a) because it is important to highlight to stakeholders the desirability of clearly articulated reasoning for positions and deter "black box" estimation approaches; • Energex supports principle 2(b) although it is not clear that the important requirement to *address* uncertainty is clearly captured by the phrase "appropriately acknowledge uncertainty". Energex believes this principle should be clarified; and • Energex supports principle 2(c) as it is important that outputs are stable. Energex considers that 2(b) and 2(c) are primarily relevant to the analysis output and therefore it is efficient to merge these principles.	The analysis is transparent and replicable. The analysis acknowledges and addresses output uncertainty and instability
3. Implemented in accordance with best practice:	• The requirement to use current datasets may be interpreted as circumventing the use of historical data to estimate parameters,	The methodology avoids filtering or adjustment to data unless undertaken on

(a) The implementation uses current, reliable and relevant datasets (b) The implementation avoids arbitrary filtering or adjustment to the data.	which would be inconsistent with the requirements of the Rules and the AEMC's intention. This principle is therefore not supported as it is not clearly explained and is open to interpretation; • It is Energex's view that the inappropriateness of employing unreliable or irrelevant datasets is self-evident. Energex considers that this principle is unnecessary; and • Energex considers that in certain circumstances there may be appropriate reasons for filtering datasets or adjusting data. Energex agrees that random filtering or adjustment to the data should be avoided and this should be self-evident. Energex believes a more appropriate principle, consistent with comments from the Australian Competition Tribunal in the gamma merits review decision, is that manual adjustments (including filtering) should only be undertaken if there is an economic basis for doing so.	an economic basis.
4. Recognise that there may be a need to exercise regulatory judgement. (a) The methodologies promote reasoned, transparent and predictable decision making. (b) The methodologies avoid the	• The scope and definition of "regulatory" judgement should be clarified. Energex notes that, for example, Principle 5(a) provides for objectives to be considered which (in Energex's view) are irrelevant. Energex considers that "regulatory" judgement in this context is judgement exercised in a manner consistent with the requirements allowed rate of return objective; • Energex notes that the AEMC has provided a body of explanatory material to guide the interpretation of the Rules. This should be	Regulatory judgement is exercised in a manner which is demonstrated to be consistent with the allowed rate of return objective and the intention of the Rules. The methodologies support

search for false precision.	considered when exercising regulatory judgement, particularly as this is the first instance that the new Rules will be interpreted and applied; • Energex considers that the methodologies, in themselves, should only *promote* the achievement of the allowed rate of return objective. However, the methodologies should *support* reasoned, transparent and predictable decision making (including at each Determination); and • Energex considers that desirability of avoiding the search for false precision is self-evident. Energex considers that this principle is unnecessary.	reasoned, transparent and predictable decision-making.
5. Are supportive of broader regulatory aims. (a) The methodologies are consistently applied across industries, service providers, regulators and time. (b) The methodologies are comprehensible and accessible. (c) The methodologies promote simple over complex models.	• Energex considers that proposed methodologies should not be determined with a view to objectives other than those mandated by the Rules and the Law; • As a practical matter, methodologies are applied inconsistently by other regulators and across industries and therefore it would be impossible to apply a methodology consistently across regulators and industries; • Energex considers that applying methodologies consistently across service providers may result in the service providers' regulatory proposal not being afforded adequate consideration, particularly noting the multiple possible approaches to estimating the return on debt;	N/A

	• The methodologies might only be applied consistently across time where there is no material change in circumstances that would lead to a different methodology being more consistent with the Rules. The AEMC enhanced flexibility in determining the rate of return to accommodate changing market conditions and new evidence. Whether a methodology should be applied consistently across time may also depend upon the framing and detail included in the methodology (e.g. whether and how it takes into account prevailing market conditions). This principle is not supported on these bases; and • It is important that the methodologies are comprehensible and accessible although this is not considered to be the same as the methodologies being simple. It is important to recognise that cost of capital is a complex and specialised discipline within finance and advice will be provided and debated by experts in this field.	